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# GEOGRAPHY

Russia is located in Northern Asia (that part west of the Urals is sometimes included with Europe), bordering the Arctic Ocean, between Europe and the North Pacific Ocean. The total area of Russia is about 17 million km<sup>2</sup>. Russia's land boundaries total 20,139 km; shared with Azerbaijan 284 km, Belarus 959 km, China (southeast) 3,605 km, China (south) 40 km, Estonia 290 km, Finland 1,313 km, Georgia 723 km, Kazakhstan 6,846 km, North Korea 19 km, Latvia 217 km, Lithuania (Kaliningrad Oblast) 227 km, Mongolia 3,441 km, Norway 167 km, Poland (Kaliningrad Oblast) 432 km, and Ukraine 1,576 km.

Administratively, Russia is divided into 21 autonomous republics, 49 oblasti, 6 krays and 10 autonomous okrugs, with Moscow and St. Petersburg having the status of federal cities. Russia accounts for more than half of the population of the Commonwealth of Independent States, and for 60 percent of their GDP.

Russia's climate ranges from hot and dry in the steppes in the south through humid continental in much of European Russia; subarctic in Siberia to tundra climate in the polar north; winters vary from cool along the Black Sea coast to frigid in



## Russia

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Siberia; and summers vary from warm in the steppes to cool along the Arctic coast.

The terrain is broad plain with low hills west of Urals; vast coniferous forest and tundra in Siberia; and uplands and mountains along the southern border regions.

Natural resources include a wide natural resource base including major deposits of oil, natural gas, coal, many strategic minerals, and timber. The formidable obstacles of climate, terrain, and distance hinder exploitation of natural resources.

Current environmental issues include air pollution from heavy industry, emissions of coal-fired

electric plants, and transportation in major cities; industrial and agricultural pollution of inland waterways and sea coasts; deforestation; soil erosion; soil contamination from improper application of agricultural chemicals; and scattered areas of sometimes intense radioactive contamination.

Natural hazards include permafrost over much of Siberia that is a major impediment to development; volcanic activity in the Kuril Islands; and volcanoes and earthquakes on the Kamchatka Peninsula.

# DEMOCRAPHICS

The population of Russia totalled 149 million in 1995. Twenty-two percent of the population is under the age of 14 years; 66 percent between 15-64 years; and 12 percent are 65 years and over. Over 73 percent of the population live in the urban areas; Moscow, the capital of the Russian Federation, has 9 million inhabitants.

The population growth in Russia in 1995 was 0.2 percent. The birth rate was 12.64 births per 1,000 population, while the death rate was 11.36 deaths per 1,000 population. The net migration rate was 0.7 migrants per 1,000 population. Demographic indicators are presented in Table 1.

The nationality is Russian. The population is ethnically diverse and consists of more than 120 ethnic groups and nationalities.

Ethnic divisions include Russian (81.5 percent), Tatar (3.8 percent), Ukrainian (3 percent), Chuvash (1.2 percent), Bashkir (0.9 percent), Byelorussian (0.8 percent), Moldavian (0.7 percent), and other (8.1 percent). Major religions include Russian Orthodox and Muslim. The predominant language is Russian.

**Table 1:  
Demographic Indicators**

Population (million)	149
Population Density (per km <sup>2</sup> , 1994)	8.7
Population by Age	
0-14	22%
15-64	66%
65+	12%
Literacy Rate	98%
Population Growth (% 1992-95)	0.2%
Urban Population (% of total, 1994)	73.1%
Human Development Index (ranking out of 174 countries, 1992)	52
Cities with over 1 million Inhabitants (1995)	Moscow, 9.0 St. Petersburg, 5.0 Novossibirsk, 1.4 Nizhny Novgorod, 1.4 Yekaterinburg, 1.3
Growth Rate of Largest City (% 1990-95)	Moscow, 0.4%

Sources: EBRD, 1996; EIU, 1995; UNDP, 1995, WB, 1996

## ECONOMIC OVERVIEW

With vast oil, gas, coal and timber reserves in Siberia and the Russian Far East, and minerals in the Ural mountains, Russia is rich in natural resources. The industrial sector is diverse. In addition to resource-based industries, Russia has developed a large manufacturing capacity. Russia is a leading producer and exporter of fuel, gold and minerals, and it has the fourth largest fishing industry in the world. Following the transition to a market economy, Russia's huge defence industry has rapidly converted to civil use. Agricultural production, mostly grain and potatoes, has a long tradition and accounts for about 13 percent of GDP. The radical reform of the industrial sector is one of the major tasks of post-communist transformation in Russia.

Since 1991, Russia has initiated the economic and political transition to a free market economy. The government has liberalized most prices and has developed a legal framework for privatization and economic restructuring. However, financial stabilization has remained elusive, and a limited restructuring of industry has occurred due to the scarcity of investment funds. High inflation, high deficit and a massive decline in industrial output are still the overriding economic problems. In addition, the lack of political stability aggravates the economic hardships. The service sector, which according to official statistics grew by almost 45 percent in 1993, continues to expand.

The restructuring process accelerated after the most recent elections in 1996. Monetary and macro-economic policies have allowed the country to curb monthly inflation to 4.5 percent, while at the same time the budget deficit has been reduced to 6 percent. However, total foreign debt is more than US\$80 billion. Russia has carried out a comprehensive currency reform, including the opening of currency exchanges and direct interbank trading. The largest commercial banks are approaching Western standards, offering a full range of services. Close to 300 banks are authorized to deal with foreign accounts. The stabilization of the economy, and the promotion of sustainable economic growth, are still major tasks ahead.

**Table 2:**  
**Key Economic Indicators and Projections**

	1994	1995	1996 (est.)
Real GDP (% growth)	-12.6	-4.0	-1.0
Industrial Output	-20.9	-3.0	-2.0
GDP per capita (US\$ at Purchasing Power Parity [PPP])	4,290	4,224	N/A
Average Gross Monthly Wages (2 Qtr in Rbl, 000s)	187.5	432.2	746.5
Private Sector Share of GDP	50	55	55
Unemployment Rate (%)	3.6	7.0	7.9
Inflation Rates	307	198	52
Average Exchange Rate (Rb: \$US)	2,191	4,558	5,200
Trade Balance (US\$ billion)	23,113	31,078	N/A
Foreign Direct Investment (US\$ billion)	1.0	2.0	3.6

Sources: EIU, 1996b; ECE, 1996; WB, 1996

Economic reforms have created a dynamic private sector, accounting for 50 percent of GDP in 1995, although some estimates also suggest that the shadow economy accounts for 40 percent of the Russian economy. Russia has made significant headway in the privatization of several economic sectors, completing its voucher privatization program in mid-1994; seventy percent of the state industry has been privatized. More than half of the work-force is in the private sector. Capital flight continues to be a serious problem with an estimated US\$60 billion moved from Russia to European bank accounts over the last five years.

GDP per capita in 1995 was US\$4,224, which is slightly lower than 1994 levels. Unemployment is about 7 percent, however, the number of registered unemployed is expected to increase rapidly (forecast is 12 percent in 1997) after the massive restructuring and privatization of state enterprises. Official unemployment does not include an

estimated 4.5-5 million people who work reduced hours or are on voluntary leave.

Slow economic progress, political instability and high inflation, have had negative implications for foreign investment. Cumulative foreign direct investment was estimated at US\$6.6 billion at the end of 1996, with U.S. investment accounting for US\$2 billion of that total. The ruble crisis in October 1994, and various political disruptions, were especially critical for the flow of foreign investment (portfolio and direct) that in 1994 alone, was US\$3-4 billion. Key economic indicators and projections are illustrated in Table 2.

## World Bank Economic Assessment

The World Bank has supported the Russian Federation's transition to a market economy since June 1992. Today, the World Bank is Russia's largest foreign source of long-term financing for public sector investments. In addition, it provides important financing for the private sector through financial intermediaries and other institutions. So far, it has approved 28 loans to Russia totalling more than US\$6.4 billion. In the last fiscal year, Russia was the World Bank's third largest borrower after China and India.

The Bank's sister organization, the International Finance Corporation (IFC), is a leading direct investor in Russian businesses. In addition to its advisory work, the IFC has been actively pursuing investment opportunities since the Russian Federation joined the Corporation in March 1993. As of July 1996, IFC has approved US\$368 million for 20 projects, including post-privatization restructuring, capital markets, agribusiness, and oil and gas investments.

Of 180 current members, Russia is one of the World Bank's major shareholders. Moreover, the Russian Federation is a significant contributor of funds to the World Bank's affiliate organization, the International Development Association (IDA) which is in charge of assisting the poorest countries of the world on highly concessional terms.

Russia's investment needs are greater than the combined resources of the Government and

international financial institutions. Therefore, Russia will have to extensively rely on both domestic and foreign capital markets to finance the bulk of its massive restructuring needs. World Bank lending and technical assistance serve as catalysts for fiscal, legal and institutional reforms which will facilitate new private investment and make public investments more efficient.

The World Bank Group is helping Russia make the transition to market financing as rapidly as possible by:

- expanding the role of the private sector through support of ownership change in state-owned enterprises and assisting emerging new private businesses;
- strengthening public sector institutions supportive of a market economy through legal, institutional and fiscal reforms; and
- facilitating private investment through sectoral reform programs (IBRD sector and investment lending), mobilizing foreign financing for key private sector projects (IFC investment lending), and ensuring a stable and transparent environment for foreign investment (Multilateral Investment Guarantee Agency (MIGA) and IBRD guarantee programs).

In addition to financial resources, the Bank's projects provide access to training and technology transfer opportunities that facilitate reform efforts. These projects are intended to demonstrate in selected businesses, sectors, regions, and levels of government how processes, incentives, and, above all, institutions must change for a fully functioning market economy. These changes will enable Russia to mobilize the massive private financing needed to restructure industry, boost economic activity and raise living standards.

The World Bank is also supporting the Government's efforts to address housing conditions. In March 1995, the Bank approved a US\$400 million housing loan to assist in the implementation of housing reforms in selected cities, the pioneering of private sector involvement in housing construction, and the provision of know-how and financing to local construction industries.

## **POLITICAL OVERVIEW**

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The Russian Federation is governed by a political system modelled after many in the West. The federal system is composed of three branches: executive, legislative and judicial. The Federation is composed of 89 “subjects”, which include regions, ethnically-based autonomous republics, territories and the cities of Moscow and St. Petersburg. These “subjects” are granted some autonomy over internal economic and political issues, but there is considerable disagreement over how much authority they are to share with Moscow.

The executive branch is led by the President, who is elected for a five-year term, and has the right to choose the Prime Minister with the approval of the legislature. The Prime Minister in turn appoints ministers, who are responsible for the execution of legislation and decrees in their respective fields.

The legislative branch is comprised of a two-chamber federal assembly: the Upper House and the Federation Council which consists of two representatives from each “subject” of the Russian Federation. The Federation Council passes decrees on federation disputes and reviews legislation passed by the Lower House, including the federal

budget. The Lower House, or State Duma, is made up of 450 deputies, one half selected on the basis of geographic districts and one half on the basis of party lists. The Duma passes most federal laws. Duma members are elected to four-year terms. There are over twenty parties and factions represented in the Parliament.

A combination of key policies mark recent developments in Russia’s reform process including: fiscal discipline, commitment to privatization, economic restructuring, reorientation of trade towards Western partners, and encouragement of foreign investment.

After four decades of Cold War, the global transformations that led to the breakup of the U.S.S.R. and the emergence of the Russian Federation as an independent state in 1991 marked a new beginning in Canada-Russia relations. Agreements signed since 1992 promote closer economic and political ties as well as bilateral co-operation on environmental and northern issues. As a member of the G-7, Canada is working with its Western partners to provide more effective support for Russia’s political and economic reforms.

## **TRADE POLICY**

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Russia's trade is dominated by Europe, with Germany and Eastern European countries as major trading partners. Trade volumes (particularly industrial products) with the other countries that form part of the Commonwealth of Independent States (CIS) are significant, particularly with Ukraine and Kazakhstan. Russia continues to supply large amounts of energy to these countries at discount prices, although it has tied government credits to the repayment of the former Soviet Union debt. Japan and China are Russia's largest Asian trading partners, while the U.S. position in foreign trade is becoming stronger.

By 1994, Russia liberalized domestic trade and eliminated all non-tariff restrictions on foreign trade; phased out the system of quotas and licensing for exports; and signed a cooperation and partnership agreement with the European Union (EU), which will come into effect in the summer of 1997. Russia's foreign trade totals US\$147.7 billion, a 4-percent increase from 1995, while trade with the Commonwealth of Independent States (CIS) accounts for US\$34.2 billion, a 6-percent increase compared to 1995. Despite the imbalanced economic restructuring, Russia has had a trade surplus since 1993 due to the increase in the export of commodities such as petroleum and aluminium, and a reduction in the import of food products.

In 1995, trade between Canada and Russia totalled about \$706 million, with about \$208 million worth of exports from Canada to Russia and \$498 million of Russian imports. Bilateral trade continues to expand in regions such as Russia's far east where significant new opportunities are emerging.

Canada and Russia signed a double taxation agreement in June 1985, and a second treaty is under preparation for ratification by Canadian and Russian parliaments in 1997. A formal agreement between Canada Mortgage and Housing Corporation (CMHC) and the Ministry of Construction of the Russian Federation was signed in October 1995. It facilitates the exchange of information, know-how and technology, as well as collaboration with respect to codes and standards to eliminate barriers to trade in the construction sector.

The Canadian International Development Agency (CIDA) administers a special Canadian Cooperation Program with Russia, which aims at increasing Canadian trade and investment, and supports Canadian-Russian partnerships in a variety of areas including energy, agriculture, environment, democratic development and social protection.

## HOUSING CONDITIONS

Since independence, the housing sector in Russia has undergone a significant transformation marked by privatization and a reduced government role in the production and allocation of housing. Although the quality varies tremendously, particularly between urban and rural areas, the housing stock is inadequate to meet the needs of Russian households. Experts estimate that 25 percent of households share a dwelling or live in dormitories. Housing shortages are evident in the growing number of households in the queue for state housing that reached a record 10 million in 1992. In large cities, which accommodate 63 percent of the urban population, individual construction was forbidden until 1988. In addition to distribution inefficiencies, the state monopoly over housing provision and the policy of government paternalism also contributed to chronic housing shortages. Table 3 illustrates estimated urban housing shortages in 1990.

**Table 3:**  
**Estimated Urban Housing Shortage, 1990**

	Households (000s)	Urban Units (000s)	Households/ Dwelling Units
Moscow	3,683	2,812	1.31
St. Petersburg	2,155	1,288	1.67
Total Russia	43,159	33,500	1.29

Source: WB, 1995

Recent policy reforms have changed the existing tenure structure. At the national level, the proportion of owner-occupied urban housing in 1993 was close to 27 percent compared to 72 percent in the rural areas. Local governments owned 36 percent of urban housing, while public agencies and enterprises owned 22 percent.

Housing consumption is very low by European standards, with an average floor space of 16.7 m<sup>2</sup> per person; some 31 percent of the households had less than 9 m<sup>2</sup> per person. Shortages are more acute in the urban areas. Density indicators

highlight another dimension of housing problems, namely the size of dwellings in the urban areas is inadequate compared to the average household size. Overcrowding is reflected in the high ratio of households per dwelling and some estimates suggest that 45 percent of families in the cities lack separate dwelling space.

**Table 4:**  
**Housing Conditions by Tenure Type, 1993**

Indicators	Urban	Rural
Tenure Type (% of the housing stock) 1993		
State-owned	22.0	15.0
Municipal	36.0	4.0
Public & mixed	10.0	9.0
Owner-occupied	27.0	72.0
Housing Co-ops	5.0	0.0
Average floor space per person (m <sup>2</sup> )	15.7	18.4
Average size of dwelling (m <sup>2</sup> )	51.0	47.0
Households/Dwelling units	1.11	0.87
Housing stock (mil. m <sup>2</sup> )	1,721	710
Apartment units (000s)	33,578	14,816
Housing built after 1960 (%)	78.3	69.9

Sources: WB, 1995; Kosareva et al, 1996

The distribution of the housing stock by age and type is relatively uniform, with more than 75 percent of the housing built after 1960. A large proportion of urban housing consists of mass-produced highrise apartment buildings, particularly prefabricated 9-12-22 storey buildings with small 55-70 m<sup>2</sup> apartments. These dominate the urban landscape of over 150 large urban centres in Russia. More than 33.5 million units in the urban areas are in multi-family apartment buildings. Privatization has resulted in mixed ownership (individual and municipal) in most of the buildings, and this has created extreme

problems for maintenance and management. Table 4 shows housing conditions by tenure type in 1993.

Dachas (temporary residences) attracted a large share of household savings under communism. However, their year-round use is prevented by the frequent lack of utilities, poor transportation, and no social services.

Housing quality is a major problem in Russia where more than 40 percent of the housing stock needs major renovation and upgrading. The share of substandard urban housing is over 7 percent. Some estimates suggest that 420 million m<sup>2</sup> of state-owned housing requires repair work at a cost of US\$10 billion. So far, due to chronic shortages

of funding, the government has delayed maintenance and is not considering a comprehensive program of housing rehabilitation.

Water supply and sewerage systems are much better developed in urban areas, as cities have traditionally attracted a larger share of state investment in infrastructure and services. Lower levels of infrastructure provision in the rural areas has led to a much lower quality of rural housing. Over 50 percent of the rural housing lacks running water, sewage facilities and central heating. The quality of owner-occupied urban housing is drastically low; over 80 percent lack basic amenities. Table 5 shows housing quality characteristics in urban and rural units in Russia in 1990.

**Table 5:**  
**Housing Quality Characteristics in Urban and Rural Units, 1990**

Tenure Type	URBAN				RURAL			
	Water	% units Sewage	Central Heating*	Bath	Water	% units Sewage	Central Heating*	Bath
State-owned	91.9	89.8	89.9	85.2	48.0	37.6	40.3	33.8
Municipal	94.0	92.9	91.5	89.2	47.1	39.3	44.9	34.7
Public & mixed	85.2	80.0	81.3	73.1	57.5	49.8	55.5	42.1
Owner-occupied	17.9	11.1	31.2	6.5	N/A	N/A	N/A	N/A
Housing Co-ops	99.9	99.9	99.9	99.9	99.4	99.4	97.8	99.3

\* Defined as percentage of dwellings provided with any heating installation serving one building or one flat.  
Source: WB, 1995

# **HOUSING SECTOR**

## **Overview**

Since 1992, there have been considerable efforts to restructure Soviet housing policy. Housing reforms have been driven largely by changing political, economic and social conditions, and include a series of ad hoc measures. The Russian government has focussed its efforts on the privatization of state and enterprise-owned housing, measures to improve the existing housing stock, and the mobilization of private funds and initiatives for new housing provision. Subsequent legal reforms have clarified property rights and established a framework for the operation of land and property markets. The increasing government deficit has affected the amount of housing subsidies available, which in turn has contributed to the decline in housing input and decreased capital investment in the sector.

## **Relevant Regulatory Systems**

Housing privatization was one of the earliest reforms carried out by the Russian government. Under communist rule, Russia had the most distorted urban ownership structure among the centrally planned economies. In 1992, 83 percent of the housing stock was under state control in Russian cities, with almost 100 percent of housing in major cities like Moscow and St. Petersburg under state ownership. Consequently, housing privatization is mainly an urban issue.

According to the Housing Privatization Law adopted in 1991, local government and enterprise housing is subject to privatization. The Law entitled each tenant to a free-of-charge transfer of floor space per person and a payment of the difference between the value of the unit and the entitlement assessed at the average price per m<sup>2</sup> in each locality. Amendments to the Federal Privatization Law in 1992, allowed for a give-away transfer, which substantially affected the pace of privatization, particularly in the municipally owned stock. So far, most of the units have been transferred free of charge.

Despite these economic incentives, 32.4 percent of the eligible housing was privatized by the end of

1994, totalling 2.4 million apartments. However, the gains in tenure security are minimal, and households are concerned about rising maintenance and renovation costs, particularly in the older units. The propensity to privatize varies in different cities or sub-markets. Housing privatization represents a significant socio-economic change in Russian society, that might accelerate with the further development of property markets.

## **Housing as a National Priority**

Housing subsidies in the state budget cover investment in the provision of municipal housing, cost differences in public rental housing and subsidies to homeowners and renters. In 1992, housing related subsidies were 6.1 percent of the federal budget, up to 2.2 percent of GDP. Implicit housing subsidies, especially energy subsidies, remain large. The state budget traditionally has been the major source of financing for housing construction, supplemented by some contributions from enterprise funds. The total volume of federal capital investment in 1994 was close to US\$1 billion, mainly for new housing construction for military personnel and victims of Chernobyl. With the return of 750,000 military personnel from Central and Eastern Europe, the Russian Federation is facing a severe housing shortage. Canadian companies are pursuing sales of construction materials and technology. Successful model housing projects in Siberia showcase Canadian expertise in the field of cold climate construction.

With shrinking funds for new construction, investment in maintenance and repair has fallen from 60-70 percent of the needs in 1990, to 25-30 percent in 1993. In order to offset maintenance costs the Russian government transferred responsibilities for the operation and management of state housing to the local governments. With price liberalization, housing subsidies reached 12 percent of local budget expenditures, resulting in deferred maintenance, and a reduced flow of municipal services. Rents were insignificant, accounting for 1 percent of the maintenance costs in 1992. Since December 1992,

local governments have been committed to achieving a 100-percent cost recovery for housing and communal services, within the next 5 years. Although housing allowances have existed since 1994, there is no systematic information on the operation of the system. Anecdotal evidence indicates that less than 10 percent of the eligible households received subsidies to cover their rent in 1995.

A number of new regulations, laws and guidelines in Russia provide the legal framework for the housing sector. The Russian government made important progress in developing market-oriented urban laws between 1992-93. The former Soviet legislation has gradually been replaced, addressing the most important issues such as property rights, privatization of dwellings and land, property tax, physical planning and construction.

The Russian Federation's Constitution was amended to permit ownership and free trading of land for housing and properties, and the previous restrictions on property rights were abolished. The Law on Local Self-Government in the Russian Federation introduced the concept of municipal property and emphasized the decentralization of public services. Municipalities have acquired additional responsibilities including the management and operation of publicly-owned housing, but are still dependent on central government transfers. Municipal authorities approve urban planning documents, lease and sell municipally owned assets, and manage the urban development process.

The adoption of a legal act "On Foundations" of the Federal Housing Policy at the end of 1992, and the state program "Housing" provide the legal framework for housing reforms, while the "Law on Pledge" establishes the concept of a mortgage. Other government decrees regulate the sale of unfinished units, the maintenance of public housing through competitive tendering, and rent reform. A new Condominium Law is currently under review.

A law "On the Basic Principles of Urban Development in Russia" was passed in July 1992, identifying the roles and responsibilities with respect to the provision and maintenance of technical infrastructure, building permits and zoning regulations. A Land Code and Urban Planning Code have been approved, and a major

effort has been made to develop unified European Union (EU) standards, particularly in areas such as construction and fire safety, energy efficiency, and quality guarantees. This is reflected in the Decree on Standardization and Certification.

## Key Housing Market Institutions

The Ministry of Construction is actively involved in coordinating building activities, planning major construction projects, and defining housing and construction policies. Oblast and city governments are playing a vital role in housing and urban reforms; under the Law of Local Self-Government, a substantial authority was delegated with respect to land use management and housing in cities, townships, districts and settlements.

Other major institutions are the municipal maintenance companies that manage state and enterprise-owned housing. Moscow is experimenting with contracting out maintenance work to private companies through competitive bidding in order to cut down on costs. Major changes have occurred in the institutional framework for new housing production. Privatized construction companies and producers of building materials are still the main participants involved in the process.

Trests, which typically employ a few hundred to a few thousand people, are the general building organizations responsible for much of the site work. Kombinats manufacture prefabricated housing and assemble apartment buildings. Close to 2,700 kombinats exist in Russia; however 4 in Moscow produce 60 percent of the total housing stock. The mass privatization programs between 1993-94 shifted most of the state construction and building material enterprises to private ownership. In the vast majority of cases, management and workers have become the controlling shareholders. This has not improved production efficiency and management practices significantly. Russia's privatization has resulted in the ownership by company insiders who hold a majority stake in more than half of the privatized firms.

A growing number of private construction firms and developers have emerged, building mostly for the elite housing market in Moscow and St. Petersburg.

Housing financing is the monopoly of Sberbank, though this situation is rapidly changing. A recently

established Real Estate Society represents Moscow and St. Petersburg-based agencies and is expanding to include others operating in the larger urban centres. Design and urban planning institutions are still centralized, although more than 300 architects have a licence to practice, and 100 private firms exist in Moscow. A Society of Independent Architects has been established in Moscow with 70 founder members.

## State of the Local Housing Market

Major changes have taken place in the housing investment portfolio. The enterprise share has increased dramatically to over 50 percent in 1993 alone. The local government share, which was non-existent in 1986, has risen to 6 percent. The share of financing from the population (private and co-operative) has remained relatively stable. Due to budget deficits, state construction projects have been reduced. The Russian style private enterprises and other organizations, financed about 10 percent of new housing in 1993, offsetting the reduction in central government spending. The volume of residential construction has remained relatively stable, in the range of 16 percent of the total national investment. Table 6 shows housing investment in Russia for the period 1987 to 1993.

The production of new housing decreased dramatically from 1.2 million units in the 1980s, to 600,000 units between 1993-94. Housing output by state organizations and enterprises was 80 percent of the total up to 1990, declining to 41 percent by 1994. Private development has maintained a steady output level, while

cooperative housing has decreased by approximately 40 percent. Private sector activity is also considerably affected by the recession, sharply rising prices, inflation and falling real incomes. A large number of unfinished dwellings are a major problem for private and public developers. Local governments are developing pilot projects for the completion of buildings using input from housing cooperatives or contracting the work to small builders. Table 7 shows the distribution of new housing units by type of developer for the period 1980 to 1994

The federal government has focussed its attention on the funding of special needs housing, while municipal governments have taken over the responsibility for new public housing provision. However, a high percentage of the public housing (e.g., 42 percent in Moscow) is sold on the market. State and municipal housing accounted for 31 percent of the total construction (42 million m<sup>2</sup>). Housing construction by private individuals and firms has increased steadily since 1992. By 1995 it accounted for one third of the new construction.

Mixed-ownership represents share participation schemes that are, in principle, private developments for sale. In these schemes, the developer initiates the project and sells partly finished dwellings to investors. The economic rationale appears to be that investors share part of the construction risk, while buyers decide to some degree upon the construction standards they can afford when finishing the building. Typically, local government provides land or infrastructure in exchange for shares in the housing scheme, hence

**Table 6:**  
**Housing Investment 1987-93 (in million Rbl)**

Year	State & Municipal Governments	Enterprises	Co-ops & Public Organizations	Private Persons	Total **	% of Total National Investment
1987	15,709	1,367	2,446	653	20,180	15.7
1991	30,800	19,300	4,000	9,000	37,000	15.9
1993*	198,500	988,800	37,800	96,600	1,372,900	N/A

\* Projections for 1993 in prices valid for the 4<sup>th</sup> quarter of 1992, Special Government Program in Housing.

\*\* Total estimates exclude housing investment by other organizations which in 1991 were 20 million Rbl., and increased to 145 million Rbl. in 1993. Also defence budget funds accounted for 206 million Rbl. in 1993.

Source: WB, 1995

**Table 7:**  
**New Housing Units by Type of Developer, 1980-94**

Developer		1980 (000s)	1990 (000s)	1994 (000s)
Private Sector	Cooperatives	52	52	31
	Private persons	72	79	77
	Collective farms	61	47	-
Public Sector	State Organizations/ Enterprises	997	835	242*
	Public organizations	8	31	1
Total		1,190	1,044	595**

\* Includes municipal housing construction.

\*\* Includes mixed-ownership housing development.

Source: Kosareva et al., 1996

the term mixed. The shares of private and mixed types of new housing developments amounted to two thirds of new construction in 1995. Estimates for 1996, indicate a further increase to nearly 80 percent, which contrasts with the situation in 1990 when 80 percent was public.

According to the Land Code, Russian citizens have two options for land ownership for residential use: private property over land for single-family housing; and a lease for 49 years under the responsibility of municipal authorities. The size of lots is specified in the new Russian Building Code. The ownership of privatized or cooperative apartments is not accompanied with a corresponding ownership over the land and this creates a certain complexity and ambiguity in the land markets, leading to higher levels of uncertainty in property transactions. More than half of the land users lack the proper documentation to claim land title.

Land costs vary according to the size of the city and location. Land prices for single-family housing increased substantially between 1994-95. In the early 1990s, land prices in the centre of Moscow were 1.5 to 3 times more expensive than land prices in suburban locations, within a 25 km distance. Local governments and the state still own most of the land, consequently limiting the supply. This is a barrier for the efficient operation of land markets. In addition, jurisdictional and titling problems are driving land prices upwards.

Since the elimination of subsidies, production costs have increased under the influence of increasing energy and materials prices; the price of building products has increased 10-15 times. Actual construction costs have increased 2,200 times,

compared to those in 1985. One m<sup>2</sup> of housing space in a prefabricated building, that was Rbl 260 in 1985, reached Rbl 830,000 in 1994. In general, construction costs are difficult to forecast and estimates do not remain valid for long due to inflation and uncertainty about the availability and cost of building materials. It is estimated that 45 percent of the cost covers the contract work, 15 percent is allocated for project development, 5 percent for plan preparation, 9 percent for setting up the building site, 3 percent for approvals, 10 percent for utilities, and 3 percent for operations management.

Costs in 1994 were \$211-350 per m<sup>2</sup> nationally. The average size of newly built units has increased substantially, to 65 m<sup>2</sup> compared to 59 m<sup>2</sup> in 1990. The largest units are built by private developers and individuals, reflecting the demand for single-family, 3-4 bedroom housing. Table 8 shows construction costs and size of newly built housing in 1994.

**Table 8:**  
**Construction Costs and Size of Newly Built Housing, 1994**

Type of Investor	Construction costs*	Size of Newly Built Housing **
State	304	62
Municipal	294	60
Public Organizations	211	70
Private Firms	299	79
Mixed	297	59
Total	259	65

\* Prices are given in US\$ per m<sup>2</sup>.

\*\* Unit size is in m<sup>2</sup>.

Source: Kosareva et al., 1996

# MATERIALS, LABOUR AND FINANCING

## Overview

The privatization of the building industry accelerated in 1993 following the government decrees "On Privatization of Enterprises and Organizations in Construction and Building Materials' Industry", and "Regulations on Privatization Specifics of Enterprises and Organizations in Construction and Building Materials' Industry".

Significant restructuring of the building materials industry is currently taking shape with the appearance of new amalgamated enterprises, local administrations, industry associations and joint stock companies. The fast pace of decentralization within the sector, as well as the privatization within the industry, have caused an overall decrease in production and the shutdown of a number of enterprises.

According to the Ministry of Economy, foreign investment in Russian enterprises at the end of 1993 amounted to US\$2.7 billion, of which 14 percent was invested in the construction and building materials' industry.

Available data indicates that the industry is still dominated by large-scale construction enterprises with more than 200 employees. However, a number of new private firms have emerged in the last four years operating more efficiently in the market environment. These firms are mainly involved in the renovation of housing and commercial space, and the building of new cottages. However, new housing construction is still dominated by large state producers that continue to build prefabricated housing on the outskirts of the cities. While the industry has 2,700 kombinats, with a total annual production capacity of over 40 million m<sup>2</sup>, its current output is less than 12 million m<sup>2</sup> and decreasing.

## Materials

The building materials industry is organized into 20 sub-branches, with over 14,000 enterprises employing more than 1.3 million people. Russia has 46 cement plants; 2,000 plants producing raw

materials; 2,700 precast factories or kombinats; 59 porous aggregate plants; 42 building ceramic plants; 2,600 gravel and crushed stone plants; and 90 thermal insulation factories. The building materials industry has the capacity to respond to the needs of the domestic market for traditional construction materials. However, its technology and quality standards need considerable improvement.

At the beginning of 1994, close to 20 percent of the building industry had been privatized. The privatization of construction contracting organizations, and construction industry and building materials enterprises, is practically complete.

**Table 9:**  
**Local Production of Building Materials, 1991**

Building Materials	1991
Small Concrete Blocks (million t)	2.5
Prefabricated Concrete (million t)	75.1
Lime (million t)	4.46
Bricks (billion)	23.7
Plaster (million t)	2.28
Roofing tiles (million m <sup>2</sup> )	9.0
Window glass (million m <sup>2</sup> )	127.5
Thermal insulation (million m <sup>3</sup> )	14.95
Sawnwood (million m <sup>3</sup> )	65.77

Source: United Nations, 1994

The output of the building materials industry in 1993 was only 83 percent of the 1991 figure. Although it is difficult to provide accurate statistics on recent domestic production, the general trends are related to the reduced demand in the domestic market. Research indicates that output continues to fall, while imports of finishing and value-added products are growing steadily. Local production of building materials in 1991 is shown in Table 9.

While prices for locally produced building materials have increased dramatically, 10-15 times after the liberalization of prices in 1992, the quality is poor at best.

## Labour

Russia has a skilled and well-educated labour force. Under the national law, salaries must be paid every two weeks in rubles. Most companies set the salary in dollars and then pay according to the exchange rate at the time. In the construction sector, Russian companies face a lot of competition in Western investment and development projects, particularly from Finland, Sweden, Germany, Italy, Turkey, and Yugoslavia. Though Russian contractors and workers are rapidly learning new techniques, their efficiency generally falls short of Western standards. However, upper level engineers and employees in building management are very qualified. Western trained Russian employees and expatriates are earning top annual salaries of US\$60,000-120,000, with significant fringe benefits. The job markets in the regional centres are not as developed as in Moscow and St. Petersburg and consequently, foreign businesses need to train their employees.

## Financing

Mortgage banking in the Russian Federation appears to be not as well-developed as in other Central European countries, due to the failure of macro-economic stabilization and the delay in mortgage legislation. By mid-1995, Sberbank and other financial institutions reportedly offered 10-year loans at either an adjustable or indexed rate, while fixed interest rates were typically available for one year. The dollar-denominated loan at a fixed dollar interest rate of 30-40 percent has become the most widespread indexation

instrument available, while the ruble interest rates reached 110 percent at the end of 1995. It is estimated that less than 10 percent of Russian homebuyers use debt financing. Due to credit risk problems in other sectors, banks have recently become more interested in mortgage financing.

In Russia, one of the few options for housing financing during hyper-inflation was a "pay in advance for your unit" scheme. Housing certificate schemes have since emerged, promising the investor a constant m<sup>2</sup> amount of newly constructed dwellings, although many of these schemes have failed. The equity-financed market for newly built housing on an instalment basis is an attempt to overcome the barriers created by the inadequate formal housing financing system. Existing homes are typically purchased using a single cash payment. Without access to formal housing financing through financial intermediation, the circle of housing investors is considerably reduced.

The Deferred Adjustable Instrument for Russia (DAIR) has been promoted and used by Mosbusinessbank. The objective is to guarantee the lender a payment rate that secures a constant spread over its refinancing rate (here inter-bank lending rates), while the remaining debt service is deferred. The loan term is 10 years. The advantage of the Dual Rate approach over the Dual Index approach, is that the amortization period of the loan can be fixed in advance, however at the cost of not explicitly controlling the debt-service-to-income ratio. Dual-indexed contracts can contribute to financial deepening in housing financing, even under high inflation by making loans more affordable. However, there is a substantial credit risk associated with the schemes, which are difficult to price under present economic conditions in the Russian Federation.

# **HOUSING MARKET ACTIVITY, NEED AND DEMAND**

## **Local Housing Activities**

The huge transfer of wealth that accompanied housing privatization has sparked the development of a private housing market. The number of transactions reached 125,000 (4 percent of the stock) in Moscow in 1992, while another 65,000 apartments changed hands in 1993. Both housing mobility and trading are rising significantly. Most transactions are financed by cash, mostly in U.S. currency, with the selling price 2-2.5 times the construction cost. The prices of newly built housing are 15-20 percent higher than prices in the secondary market.

The demand for elite housing outstrips supply by a factor of two or three. Apartments in prime central locations sell for US\$3,000-7,000 per m<sup>2</sup>. These units are often lavishly renovated units in former communal apartments built during the Stalinist era, or special low-rise housing built for high-level government bureaucrats in the late 1970s. The cottage market is also expanding rapidly, with prices in Moscow ranging between US\$300-3,000 per m<sup>2</sup> depending on factors such as amenities and accessibility. Real estate agents reported prices in the upscale market as high as US\$600,000-800,000 in early 1996. Table 10 shows house prices in Moscow in April 1995.

Of the 1,000 real estate firms in Moscow, 20 of the larger firms sold 40-50 units per month between 1994-95. About 15 foreign agencies employing less than 20 people stand out.

A diverse system of house prices has emerged reflecting location, quality, accessibility and level of services. This has resulted in the formation of distinct housing sub-markets in the urban structure. Anecdotal evidence suggests that house prices in prestigious areas of large urban centres are 4-5 times higher than the surrounding area.

**Table 10:  
House Prices in Moscow, April 1995**

Cottages-Location	Distance from centre (km)	Size m <sup>2</sup>	Price / m <sup>2</sup> US\$
Gorkovsk. shos.	1	420	524
Yaroslavsk. shos.	5	150	300
Kaluzhsk. shos.	15	220	614
Leningr. shos.	20	980	408
Kiev shos.	35	450	444
Rents per month:			
Non-renovated	N/A	70-90	100-150
Renovated up to Western standards	N/A	70-90	300-350

Source: Toda et al., 1996

## **Housing Needs**

Low wages coupled with high housing costs and mortgage rates have reduced housing demand for owner-occupied housing. Shortages of housing under the Soviet system have been replaced by shortages of affordable housing. Due to the establishment of a housing market, the ratio of average house prices to average income fell considerably during the period 1991-94. Three average monthly salaries are sufficient to buy approximately one m<sup>2</sup> of dwelling space in the urban centres. Another problem facing households is the operation and maintenance of the former public housing stock. Homeowners are struggling to raise money to pay for services previously unpaid.

Until 1994, maintenance fees in state and enterprise housing were extremely low; tenants paid 16.5 kopecks per m<sup>2</sup>, the price established in 1928. Moscow officials estimated that those contributions covered less than 1 percent of

maintenance costs. Charges for communal services were also heavily subsidized. The reduction in subsidies has led to rent increases calculated under a schedule designed to achieve a 100-percent operating cost recovery in 1998. Despite the 10-fold rent increase in 1994, the overall rent-to-income ratio is extremely low, in the range of 3-4 percent of the average household income. To maintain an acceptable level corresponding to inflation, payments need to be adjusted on a quarterly basis. Table 11 shows statistics on housing costs in the owner-occupied and rental sectors for the period 1991-94.

## Factors Affecting the Demand for Housing

According to the last census, Russia has 50.1 million households, averaging 2.5 persons per unit. Although the population of Russia is declining, chronic housing shortages in large cities exercise considerable pressure on housing demand. Additional demand may occur in large urban areas as a result of relaxed residency restrictions after independence from the Soviet Union. Economic restructuring is likely to fuel internal migration by people who have lost their jobs, although it is unclear whether this will push people towards or away from cities.

Income differentiation in post-communist societies has crucial implications for the housing market. The average gross nominal wage in the second

quarter of 1996 was close to US\$145, a 50-percent increase compared to the previous year. Although home-ownership is perceived to be a desirable and good investment in an inflationary context, very few (less than 5 percent of the households) will be able to enter the housing market in the foreseeable future.

**Table 11:**  
**Housing Costs in the Owner-occupied and Rental Sectors, 1991-94**

	Public Sector Rentals (as a % of average income)	Owner-occupied
	Rent and Utilities	Ratio of house-price-to-income
1991	1.8	1:12
1992	2.0	1:46
1993	0.8	1:24
1994	10.0	1:10

Source: Kosareva et al., 1996

A demand for high quality flats and single-family homes from the new middle and upper classes might be significant for the new owner-occupied market. Various income groups are also willing to invest in the upgrading of their existing housing, consequently spurring an increase in renovation activity.

# **EXPORT OPPORTUNITIES AND STRATEGIES**

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## **Overview**

Although progress in economic and political reform has been slow, the Russian market offers a number of opportunities for Canadian housing exporters.

Russia is the largest market in Central and Eastern Europe for Canadian housing products, worth \$36.8 million between 1993-95. The most dynamic growth has been observed in the export of roof, floor and wall products (7,345 percent), finishes (1,616 percent), and HVAC and wood products (close to 200 percent each). Exports of those products constitute approximately 50 percent of Canadian housing exports in the Russian market. Shipments of prefabricated housing were significant, accounting for \$18 million between 1993-95. In general, the market for construction products is volatile and experiences substantial gains and losses from year to year for particular product categories. Table 12 shows the value of Canadian building material exports for the period 1993-95.

Exports to Russia increased by 40 percent, with the overall increase in most product categories in the range of 100-120 percent in the first months of 1996, as compared to the same period in 1995. The Canadian involvement in the Russian market is diverse, and includes a range of product exporters, developers and service providers. More than 110 firms have been active in the Russian market in the last three years.

The existence of a large Canadian community of Russian origin has enhanced Canada's commercial relations. A significant number of joint ventures has been registered and overall business activity has increased rapidly. A number of Ontario builders are exploring the Russian market for prefabricated housing. The Drerup Armstrong home building firm, located in Carp near Ottawa, has introduced Canada's traditional wood-framed house to the Russian market. Several other home builders, such as Tommar Construction of Hamilton, are involved in joint ventures.

## **Export Opportunities**

### **Competition**

Exports in the residential sector of the Russian market are quite diverse, with no country achieving a dominant position. Together with traditional Russian business partners such as Germany, France, Italy, Finland, Hungary, the Czech and Slovak Republics, Ukraine, and Austria, new contacts are emerging, especially with Britain, Holland, Turkey and the U.S. Although significant shipments to Russia have occurred in the last three years, Canada's overall ranking in the export market for building products is still low, with sales volumes, in a comparative perspective, generally small. German, Italian, and Finnish suppliers of building materials have gained a strong foothold in the Russian market. Foreign contractors, mainly Finnish, Swedish and Turkish firms, have performed renovations of modern supermarkets, shops, housing and hotels.

Since the liberalization of trade, the East European companies have lost their strong position in the Russian market. However, statistics reveal that Poland, the Czech Republic and Romania are among the leading exporters of construction equipment. Among the Western partners, German and Swedish firms are the most active. These companies benefit from long-standing relationships with local end-users and traders, and pursue aggressive marketing campaigns.

### **New House Building**

According to the Russian Government Program for Residential Construction, projected volumes are expected to increase to 100 million m<sup>2</sup> by the year 2000. The program anticipates a continued strong consumer demand for new housing. However, local contractors will have serious problems reaching these targets due to the current difficult economic climate in the industry caused by the disruption of business relations with the former republics, and the rising costs and poor quality of domestically produced equipment and building products.

**Table 12:**  
**Value of Canadian Building Material Exports, 1993-95 (thousands)**

	Prefab. Buildings	Wood Products	Doors/ Windows	HVAC	Roof, Floor, Wall Products	Finishes	Tools and Heavy Equipment	Misc. Building Products	Total per year
1993	10,738,317	136,466	73,348	1,413,611	2,742	372,435	5,290,020	58,796	18,085,735
1994	3,771,168	931,330	740,355	455,033	10,500	23,045	1,363,374	557,032	7,851,837
1995	3,326,166	2,634,978	1,363,046	1,391,804	794,958	790,857	7,422,497	663,724	36,847,658
Growth 1994-95	-6%	183%	84%	206%	7345%	1616%	-44%	-91%	
Category Rank	1	3	5	4	6	7	8	2	
Total per category	18,035,651	3,702,774	2,176,749	3,260,448	794,958	790,857	7,422,497	663,724	36,847,658

Source: Industry Canada's Strategic trade data on-line, 1996

The proposed annual investment in residential construction is estimated at approximately US\$500 million. The Russian government hopes to obtain a US\$400 million loan from the World Bank to achieve this target, including more than US\$100 million for the expansion and modernization of existing construction industry production facilities.

International loans for housing construction are becoming a viable option. The International Bank for Reconstruction and Development has agreed to a multi-million dollar loan to St. Petersburg for a 20-year term at 7.5 percent interest. The bank will allocate about US\$100 million for the construction of new housing, plus a further US\$80 million for construction industry enterprises. The money will be used to finance the development of plots of land, selected by the municipal authorities and bank experts, for new housing construction.

- Provision of Luxury Housing:** A promising niche market for Canadian builders exists in the provision of luxury and custom homes on the outskirts of Moscow, St. Petersburg, and other large urban centres in the Volga region. The type of house most likely to succeed is a traditional masonry home with upgrades such as HVAC, a custom kitchen and a security system. Volumes might range between

200-250 units per year, but profit margins might be higher than in Canada.

- Construction of Condominiums:** Private house building in Moscow and St. Petersburg is focussed on luxury apartment buildings. Medium density developments with 80-100 m<sup>2</sup> apartments equipped with fine quality finishes may be successful. The construction of condominiums and townhouses is a significant opportunity with considerable risk, although this can be reduced with careful research into local land and housing markets.
- Manufactured Housing:** Canadian exporters of manufactured housing will find the Russian market a challenge over the next 5 to 10 years. Although it offers fast and affordable solutions to the housing crisis in urban areas, manufactured housing will hardly be accepted by the mainstream single-family homebuilders. Government and international institutions might be able to provide financial support to offset part of the costs.
- Miscellaneous:** While there are clearly problems with exporting most types of prefabricated buildings, there are some types (e.g., pre-cut house packages, R-2000, modular homes, etc.) where potential opportunities exist, provided that the product

is price competitive with traditionally built housing. Another opportunity worth exploring is the use of modular technology in townhouses and low-rise apartments, where the standardized modular approach could be more successful if expanded into multiple-density housing schemes. The marketing of manufactured homes to medium-size builders and local developers as opposed to individual customers, is a better alternative for Canadian manufacturers.

### Rehabilitation and Retrofitting

- **Rehabilitation:** The rehabilitation of panel-type apartment buildings and improvement of the energy efficiency of the existing housing stock is a significant opportunity. There is a large unsaturated market estimated at US\$10 billion, including 420 million m<sup>2</sup> of state-owned housing. Canadian companies might benefit from these opportunities by exploring various technical and cost recovery options.
- **Conversion or Restoration of Centrally Located Buildings:** The restoration of historic buildings is very attractive because of their high marketability and resale price. Mixed-use commercial residential buildings in the central business district of St. Petersburg are particularly attractive. Such projects can be undertaken as joint ventures with the Canadian partner financing the restoration or conversion in exchange for future rents, a long-term lease or equity share.

### Export of Construction Technologies and Building Materials

Although the quality of Russian produced building products is substantially lower than Western products, their price is just as high. As a result, Russian firms generally prefer to buy Western products. Building products are sold through wholesale and retail shops. European suppliers are developing an increasing share of this market. Demand is especially high in major industrial cities, where many offices, shops, and hotels are being refurbished and built. The most promising sub-sectors are building materials and products for interior finishing.

- **Technologies:** Equipment is needed for the production of lower density, traditionally built, housing forms. The renovation industry urgently needs efficient, modern production technologies to assist in the upgrading of residential and commercial properties. This segment of the market is estimated at US\$150 million per year, with an annual growth between 10-15 percent.
- **Building Materials:** These markets offer steady and growing opportunities, although volumes might be small. The most promising sub-sectors are materials for light construction and fine-quality finishes such as plasterboard, wooden and laminated flooring, wooden baseboards, roofing materials and vinyl sidings.
- **Insulation:** The growth of renovation activities in commercial and residential buildings, creates excellent opportunities for Canadian building material exporters, especially those engaged in the production of thermo-insulation and hermetic sealing materials.
- **Finishing products:** The market for finishing building products, estimated at US\$350 million, experiences a 20-percent annual growth rate and is the most promising market in the short-term. A growing demand has emerged for basic finishing products such as linoleum, ceramic tiles, faucets and fittings, in particular in the Volga region. Such cities as Tver, Nizhny Novgorod, Ulianovsk and Yekaterinburg are becoming significant consumers.
- **Housing Components and Value-Added Products:** There is a significant market for the export of wood products and components used in new housing construction, particularly plastic and wooden windows and doors. Air conditioning, heating equipment and alarm systems are also competitive in this market.
- **Do-It-Yourself market:** This market is very promising but extremely price sensitive. Best sales prospects are carpeting, vinyl wall coverings, vinyl floor coverings, baseboards and trims, kitchen cabinets, standardized doors in frames, hollow metal door frames, doorstops, standardized windows in frames,

builders hardware, acoustic and suspended ceilings, lighting fixtures, paints and coatings, and tools.

### Investment in the Privatization of Building Material Production

The Russian government intends to further increase the share of private sector involvement and to encourage foreign investment in the construction industry. Companies on the privatization list will be sold through privatization certificates to employees and managers as well as at auctions. However, investment in privatized enterprises involves the potential risk of taking over companies with a huge technical infrastructure, human resources and obsolete corporate structures. Despite these risks, considerable opportunities for joint ventures exist with the local building materials industry, especially with respect to good quality, low-cost raw materials and qualified labour. With appropriate financing and management, the design and production potential of many Russian manufacturers is high, which makes local production potentially promising.

### Best Sales Prospects

The direct export of competitively-priced building and finishing products present the best opportunity for Canadian companies in the Russian market. Market prospects are good for the following products:

- wall and floor coverings;
- energy-efficient insulation;
- roofing tiles;
- partitioning walls;
- acoustic ceilings;
- automated alarm systems;
- decorative security window grating;
- plastic piping;
- thermo-insulation and hermetic sealing materials;
- glazed ceramic tiles for walls;
- wallpaper;

- window transparencies;
- floor coverings of plastics; and
- plastic wall or ceiling coverings.

With respect to the construction equipment market, the following construction machines have the best sales prospects for the next two years:

- tamping machines and vibrator road rollers;
- pavers, finishers and spreaders;
- asphalt cutters;
- mechanical shovels, excavators and shovel loaders;
- mobile cranes;
- self-propelled bulldozers, graders, scrapers;
- concrete or mortar mixers;
- concrete pumps;
- attachments; and
- complete asphalt batching and mixing plants.

Capital investment in re-equipping enterprises and the introduction of energy-efficient technologies are needed in the following areas:

- extraction of raw inputs; and
- packaging.

### Export Strategies

The Russian export market is promising. It offers significant opportunities and potential for Canadian housing exporters.

The stereotype of Russia as a homogeneous sellers' market dominated by state-owned stores and unsophisticated customers is gone. Factors such as finding the proper sales channel and customer segment, coping with domestic and import competition, responding to consumer preferences, and pricing products to the market are extremely important. However, it should be noted that the Russian market still displays unique characteristics which require special approaches and methods by Canadian suppliers.

Firms considering the Russian market will need to exercise a certain degree of flexibility. The following principal strategies are recommended:

- Many local producers are opposed to the concept of foreign firms "invading" the local

market. There might be cases where federal or local governments, due to pressure from local producers, will block large-volume sales of ready-made foreign products.

- When developing pricing strategies, Canadian firms need to take into account the considerable regional segmentation of the Russian market. While the market for a particular imported product in Moscow or St. Petersburg may be characterized by the availability of several competing import and domestic brands, heavy advertising, good consumer awareness and widespread price competition, the market for the same product in major regional cities such as Yekaterinburg or Novosibirsk may be completely different.
- The best way to penetrate the Russian market is through local distributors. The importance of Russia's fledgling distribution networks is magnified by the ongoing privatization of the Russian retail sector which has resulted in the rapid proliferation and diversification of retail outlets. Foreign suppliers can choose from a small but growing number of existing Russian distributors who can be contacted at trade exhibitions and through trade publications. However, it should be kept in mind that many recently formed Russian distributors have comparatively short track records in the distribution business, are small-volume operations, and their experience is often limited to the main cities of Moscow and St. Petersburg.
- Price, terms of payment and service are the major competitive factors for sales of construction equipment. Quality and wide-scale advertising need to be considered for exporters aiming at the private sector of the market. Most Russian end-users and intermediaries prefer consignment, leasing and compensatory transactions as the preferable types of business operations for construction equipment.
- The best approach to joint venturing for Canadian firms will be through non-state-owned joint stock companies producing similar types of products. According to current legislation, foreign investors can buy company

shares at investment tenders or stock exchanges

Companies need to adopt a realistic attitude about success in the Russian market. High market development and entry costs might be expected and a long-term strategic view is necessary when pursuing opportunities. It is not enough to provide the best possible service or product at the best possible price to succeed in the housing sector, exports or investments. Instead, several key issues need to be considered:

- The business environment is changing for the better. It creates great business opportunities, with commensurate risks.
- Opportunities for Canadian housing exporters are mostly in selected niche markets.
- Exports of building materials and technologies represent the best opportunity in the short and long-term.
- Rising costs for building materials are the major determinants in a market entry strategy in Russia. Products can make a quick entry into the Russian market but have to be competitively priced.
- The attitude towards Canadian imports is positive.
- There is little transparency in the business, legal and regulatory environments.
- Fluctuation of tax and tariff rates, as well as continuous modification of commercial laws causes confusion on the part of foreign traders and investors.
- A detailed strengths, weaknesses, opportunities and threats analysis is recommended as part of the strategic planning process.
- Individual businesses are well advised to choose a low-risk-return strategy.
- Working with a local partner, or establishing a joint venture is highly recommended in order to maximize the position of the business in the marketplace.
- Business related risks for exporters are associated with potential credit risks, insolvency or bankruptcy.

The Export Development Corporation (EDC) estimates investment risks in Russia, and publishes

indicators on the reliability of its financial institutions. In 1996, EDC administered a US\$100 million line of credit to Russian buyers of Canadian products. When tendering to the Russian government or the International Institutions projects, Canadian companies can turn to the expertise of the Canadian Commercial

Corporation (CCC), which provides strategic and financial assistance. Through its Progressive Payments Program, pre-financing might be available to companies with a turnover of less than \$50 million. The pre-financing rate is similar to the current credit margin rate.

# BUSINESS ENVIRONMENT

## Overview

Doing business in Russia is not easy, but the country has a vast potential, and opportunities do exist. These opportunities also match Canadian capabilities and expertise. The Russian business environment has evolved markedly over the past few years, and continues to change quickly.

Anyone can enter the Russian Federation with the possession of a valid passport and an entry or transit visa. Visas can be obtained from Russian embassies or consulates. Visas must be obtained before leaving Canada and the cost depends on the amount of time allowed for processing. Given a month's notice, a Russian visa theoretically costs \$20. When asking for very fast service, a Russian visa can cost \$100 dollars or more. Business travellers must have a letter of invitation from a Russian individual or organization which serves as the sponsor.

Visas of short duration are stamped with exit dates which must be strictly observed. Allowing a Russian visa to expire can result in heavy fines and tedious work with the bureaucracy for permission to leave the country. If the visa is for a prolonged stay, then an exit visa must be obtained by the traveller's sponsor after arrival in Russia.

If travellers stay more than three days in Russia, they must register their visa through their hotel or their sponsor. Failure to do so can result in grave difficulty in leaving the country. Travellers should ensure that their visa is in order before leaving Canada.

Winters can be extremely cold in Russia with temperatures in the minus 30 range not unusual. Winter clothes can be needed as early as October and as late as April. Waterproof footwear is a must all year round, and rain gear is highly recommended from April to October.

Diphtheria outbreaks have been reported throughout Russia. Travellers should be certain that all immunizations are up-to-date, especially their diphtheria and typhoid shots. Travellers should drink only boiled or bottled water throughout Russia.

Medical care in Russia, even in the major cities, is often far below Western standards, with severe shortages of basic medical supplies. Access to the few quality facilities in major cities usually requires cash dollar payment at Western rates upon admission. The Canadian Embassy maintains lists of such facilities and of English-speaking doctors.

Travellers' cheques are not widely accepted in Russia, credit cards are only accepted at establishments catering to westerners in major cities; old or worn dollar bills (or bills with anything written on them) are often not accepted even at banks.

Russian customs laws and regulations are in a state of flux and are not consistently enforced. A 600-percent duty is required to export any item with a value greater than 300,000 rubles (customs officials decide the value of what you purchased).

Even more telling of the business climate is the ever-increasing wave of crime that has swept over Russia with the passing of Soviet control. Especially problematic is racketeering, which raises costs for local and foreign businesses alike.

Although crime in Moscow, St. Petersburg and other major cities is said to be no worse than in some major cities in North America, crime in Russia is often targeted against foreigners since they are easily identified and perceived to be lucrative targets. Travellers should "dress down", and avoid loud conversation calling attention to themselves. Pick-pocketing and muggings sometimes occur in broad daylight. Canadians should exercise particular caution in airports, open markets, near major train and metro stations, and when hailing taxis. Groups of children who beg for money sometimes pick-pocket and assault tourists. Foreigners' hotel rooms and residences have also been targets, and some victims have been seriously assaulted during robberies.

Extortion and corruption permeate the business environment in Russia. Organized criminal groups target foreign businesses in many Russian cities and demand protection money (under threat of serious violence). Many Western companies hire security services, but this has not always been

proven effective in avoiding armed extortion attempts.

The currency used in Russia is the ruble. This is the only payment medium allowed. Residents and non-residents may open foreign currency and domestic accounts in authorized Russian banks. Currency may be imported and exchanged in accordance with Central Bank procedures. The ruble is not fully convertible, but a degree of internal convertibility has been introduced.

Since June 1996, provisions for account conversions between rubles and dollars in transactions lasting less than 180 days were eliminated. Restrictions on capital account operations still remain. Russian exporters are no longer required to immediately exchange 50 percent of their foreign currency earnings into rubles. Similarly, Western importers can accept ruble payments, as these can be converted into dollars. The current exchange rate as of March 1997 is 5,610 Rbl: 1US\$.

As Russia continues to make substantial progress toward becoming a market economy, the process of selling goods and services in Russia is becoming increasingly market-oriented. Factors such as finding the proper sales channel and customer segment, coping with domestic and import competition, responding to consumer preferences, and pricing products to the market are the same factors that Canadian companies deal with at home and in "mature" export markets such as the U.S. and Western Europe and are rapidly coming forward. However, it must be noted that the Russian market still displays unique characteristics that require special approaches and methods by would-be foreign suppliers.

## **Business Customs**

Attempts to understand Russian business customs must always be rooted in the knowledge that Russia has lived for over a thousand years under authoritarian and autocratic rule. Unlike other countries in Eastern Europe such as Hungary, Poland and East Germany, Russia has no institutional memory of democracy or market economy.

In these rapidly changing times, it is difficult to generalize the business customs of this vast

country, but the following are some of the most commonly followed customs.

Russian business revolves around a system of unequalled red tape. Stamps, forms and signatures comprise a frustrating maze for western business which often sees no point in the exercise. Patience, long suffering and often the goodwill of Russian partners is the only key to success. Documents carefully notarized in Canada attesting the bank accounts or viability of a company will often be rejected by Russians.

Russian businesses place a very high value on personal interaction and relationships. Business is rarely conducted on the telephone, and decisions are almost exclusively reached in face-to-face negotiations. Such meetings usually begin with an exchange of business cards (it is helpful to have yours also printed in Russian) and progress through serious, seemingly endless speeches accompanied by tea and cookies early in the day or vodka toasts for later meetings. When invited for dinner meetings, the evening can often be very long and seemingly unproductive, but may be the necessary groundwork for an agreement signed at a later date.

Russians put great stock in personal relations. A handshake may be more binding for them than the actual signed agreement. Contract sanctity is not a well institutionalized concept in Russia with the signatory or with Russian courts. There have been cases where Russian businesses simply abrogated signed contracts when difficulties arose or they deemed the contract no longer advantageous to their side.

Western business people should be aware that Russians are zero-sum thinkers. Although Westerners expect negotiations to result in win-win agreements for both sides, Russians often think that they can only win in a negotiation if the other side loses. To succeed in business, Russians often have to scheme and plot ways to circumvent rules and find loopholes in government regulations. Often Russian businesses allow this approach to spill over into negotiations with private persons and firms.

The Russian business day is 8 hours, usually from 8:30 a.m. to 4:30 p.m. and the business week is Monday to Friday. Russian is the official language, although English, French and German

are also spoken in the business community. Many Russian entrepreneurs can speak at least some English. If your business is outside of Moscow and St. Petersburg, or if you are dealing with large factories or institutes, it may be more difficult to find English speakers. For important negotiations Canadian businesses may want to hire a reputable interpreter. Russian interpreters often specialize in certain technical areas like oil and gas or biotechnology, for example.

The Russian government recognizes the following statutory holidays:

**Table 13:  
Holidays**

January 1	New Year's Day
January 7	Orthodox Christmas
March 8	International Women's Day
May 1	International Labour Day
May 2	Spring Day
May 9	Victory Day
June 12	Independence Day
November 7	Revolution Day
December 12	Constitution Day

In the event holidays occur on weekends, Russian authorities announce during the week prior to the holiday, if the day will be celebrated on the following Monday.

## Business Infrastructure

Air transport to Russia on western airlines is becoming more accessible all the time. Several western airlines fly daily to Moscow and St. Petersburg. All major Russian cities can be reached from Moscow via Aeroflot, and increasingly the joint venture airline Transaero (which has service approaching Western-standard and which flies Boeing aircraft) is flying to a number of key Russian cities from Moscow.

With the breakup of Aeroflot into many small airlines, travel within Russia is often unreliable. Domestic air travellers must often cope with unpredictable schedules and difficult conditions including deterioration of centralized systems of maintenance and quality of service, as well as overloading.

Western travellers will be required to pay a higher rate for their tickets and will generally be seated in the front cabin. This is not "first class". Travellers will find cramped, sometimes unsanitary conditions with very little space for carry-on luggage. Although food and beverages are now sometimes served on internal flights, it often pays to bring your own refreshment if you think you will be hungry. As noted, Transaero is a good alternative to Aeroflot for those cities it serves.

Moscow has four major airports that ring the city. International flights enter Moscow through Sheremetyevo II and travellers may continue to other Russian cities through any of the other three airports. Travel time to the departure airport can be as much as an hour and a half from Sheremetyevo II, and ample time must be allowed for passport control, customs clearance and baggage retrieval. A new taxi service has been initiated at Sheremetyevo II which is highly recommended. You can pay the set rate and avoid hassles with freelance taxi drivers.

An alternate method of getting around inside Russia is to travel by train. For cities as close as St. Petersburg, travellers can generally ride night trains. Trains generally arrive in the centre of the city and save many of the baggage hassles that accrue in air travel. Trains are also far more reliable, since flights are often cancelled for lack of fuel. Unfortunately, increased incidents of theft and other crimes on trains has made this mode less safe, especially for unaccompanied passengers.

Car travel is not advised except for the cities very close to Moscow. Roads are often in very poor condition and fuel is sometimes very difficult to obtain. Within Moscow and St. Petersburg the metro system provides an excellent, inexpensive means of transportation. Most major attractions in the city are very close to metro stops. Signs are all written in Russian, so it can be challenging especially if you must change lines at any point. Be sure you can recognize the spelling of all destinations before embarking on a metro adventure.

Marked taxis in Moscow and St. Petersburg are often scarce. Russians simply stand on the side of the street and put out their hand for a ride. It often takes only a minute to find someone willing to drive you. As in other big cities, you are taking a certain risk in using this method, especially if you

are alone, or it is after dark. Be sure to negotiate the fee before you get in the car, and never get in a car occupied by more than just the driver.

Moscow, St. Petersburg, Novgorod, Sochi and Vladivostok have Western style hotels. Most will cost \$200 per night or more. Russian state hotels often provide only the barest necessities and charge foreigners over a hundred dollars for rooms that may not even have hot water.

The most reliable way to send cargo to Russia is by sea. The country has a large inland water transportation system of 102,000 km, from the Baltic to the Black and Caspian Seas. Most rivers freeze between April and November, and fees for locks and canals can cost up to US\$15,000-20,000. The major ports that handle international shipments are St. Petersburg, Arkhangelsk and Murmansk in the North, Novorossiisk on the Black Sea, and Vladivostok in the East. The country has more than 300 airports, with limited cargo capacity. Moscow is the main transit point for freight aircraft for central Asia, and most of the Russian regions. The biggest cargo terminal in the Sheremetyevo International Airport is notorious for its long queues and outdated equipment.

Truck transport is the most efficient mode of transportation although costs might be high. In addition, long border delays, harsh winters and the scarcity of spare parts are further disadvantages. The construction of new roadways, as well as the reconstruction of those existing, is a key issue in the development plans for the Russian economy. Infrastructure projects include the construction of bridges, railroads, telecommunications and power plants. In 1993, the total investment in road works was Rbl 2,756 billion; close to 7.7 million km were reconstructed, and 34,600 km of roadways were upgraded. This pace of development is insufficient for Russia, which has about 100 km of roadways for each 1,000 km<sup>2</sup> of territory, and about 6 km per 1,000 inhabitants. The Russian government is concerned about the economic costs of a poor transportation system.

## Distribution and Sales Channels

A key initial decision for a Canadian firm seeking to introduce its product into the Russian market is the choice of a distribution and sales channel. Increasingly, such channels in Russia are

diversifying and becoming product and customer-specific.

Direct sales to end-users are currently the most popular approach for most suppliers of capital goods and industrial equipment. Russian end-users of these types of products are predominantly large state-owned or recently privatized enterprises. Such enterprises are typically located in and around major cities although many are in more remote, sparsely populated areas throughout the country.

Firms marketing products and services to large Russian enterprises typically operate from a representative office located in a major Russian city. Moscow is by far the most popular location for representative offices, although the number of foreign firms located in St. Petersburg and Vladivostok is growing. Due to Russia's large size and the geographic dispersion of buyers in this sector, frequent air travel by sales representatives to visit prospective buyers is a necessity.

It is important to emphasize that while foreign suppliers of capital goods and industrial equipment can and do use Moscow as a base of operations, the great majority of sales are negotiated and transacted "in the field." The number of potential buyers in this sector that are located in Moscow is very small compared to Russia's major industrial zones (i.e., the Urals region, Siberia, the St. Petersburg region and the Far East). Moreover, Russian industrial enterprises are now largely independent of central government control and usually do not have permanent representatives in Moscow. Simply put, selling capital goods and equipment in Russia without leaving Moscow is no longer a possibility.

Some foreign suppliers in this sector, especially small and medium-sized firms seeking a cost-effective alternative to establishing a representative office in Russia, utilize the services of intermediary organizations such as commission agents, export management companies and export trading companies. Such intermediaries, often possessing their own in-country office and sales personnel, can perform a variety of marketing services on behalf of Canadian suppliers such as making sales calls on prospective end-users, exhibiting the supplier's products at trade exhibitions and negotiating sales contracts.

Marketing of building products and services in Russia can be facilitated by accessing the existing network of large distributors and wholesalers. Exporting through a local partner or consolidator is a viable option. Currently there are about 70 independent Russian joint stock companies trading and importing building products; Stroimaterialintorg, Stroiopttorg and Stroicontract may be mentioned as the largest among these 70 companies. With well-developed connections and knowledge of the specifics of the market both in Russia and the CIS, these trading companies have the opportunity to purchase large consignments at lower prices, and distribute them directly among the regions all over Russia. Some of the firms already have distributors' agreements with numerous western companies.

The activity of wholesale trading companies in the housing and construction sector is no longer confined to major cities, such as Moscow and St. Petersburg. Increased consumption is significant in Tver, Ulianovsk, Nizhny Novgorod and Yekaterinburg, coinciding with the general growth of business activity in these regions.

As a result of the price liberalization in 1993, the prices of most production and consumption goods are regulated by demand and supply. The prices of building products and housing are set and negotiated freely by companies. Products in the Russian market need to be introduced on a small scale. As in other markets, sales are price sensitive, although the high quality and good reputation of Canadian building materials and products are an asset.

## Finding a Partner

Although Russia still lags behind most western countries in terms of well-developed distribution networks, Canadian suppliers of consumer goods and services and smaller-ticket equipment items are increasingly able to penetrate the Russian market through local distributors. The importance of Russia's fledgling distribution networks is magnified by the ongoing privatization of the Russian retail sector, which has resulted in a rapid proliferation and diversification of retail outlets.

Foreign suppliers can choose from a small but growing number of existing Russian distributors. These Russian middlemen firms can help the

foreign supplier by placing products with end-users, handling customs and transportation matters and even conducting advertising campaigns. Such existing distributors can be contacted at trade exhibitions and through trade publications. However, it should be kept in mind that many of these recently formed Russian distributors have comparatively short track records in the distribution business, are small-volume operations, and their experience is often limited to the main cities of Moscow and St. Petersburg, or other regional centres.

Because of these limitations, many foreign suppliers have chosen to market their products in Russia through authorized distributorships which they create from scratch. While obviously this approach entails greater expense than utilizing existing distribution networks, it can provide valuable protection for the foreign supplier's product quality and corporate image. It also allows the supplier to establish a distribution network capable of handling larger product volumes, which lowers per unit costs and increases market coverage.

In August 1992 as part of a market reform package, the Russian Parliament liberalized laws regarding agents and distributors. The previous state-controlled, -managed, and -owned distribution system was abolished, and now foreign firms are allowed to hire private agents or distributors to conduct their exporting transactions in Russia.

## Joint Ventures and Licensing

A small but growing number of foreign firms have entered into joint venture arrangements in Russia for the manufacture and sale of finished goods in the domestic market.

Firms supplying the Russian market through joint ventures seek to take advantage of lower domestic factor costs, make use of the Russian partner's knowledge of the domestic market, and circumvent high import tariffs on finished goods. Uncertainty regarding Russia's legal climate for foreign investment is a key factor preventing faster development of joint ventures as a form of market entry by foreign suppliers. Additionally, Canadian firms often have difficulty finding viable Russian partners for joint venture manufacturing because few Russian enterprises are experienced in

producing and distributing Western-standard products.

For this latter reason, joint venture projects undertaken in Russia are frequently developed in a multi-phased manner. For example, the initial phase of the project is often limited to the packaging of imported finished goods on the premises of the Russian partner and subsequent distribution of the product. After a period of successful operation in this mode, the project then moves on to assembly or addition of value-added components. With continued success, the project may progress to the final stage of utilizing a large percentage of locally-sourced raw materials in the production process.

Joint ventures in Russia are generally created in the form of a SHC, or partnership with non-state owned joint stock companies, producing similar types of products. The legislation permits foreign investment without creating a legal entity, by entering into a joint production or joint cooperation agreement with a Russian legal entity. Foreign investors can buy company shares at investment tenders or stock exchanges.

Canadian companies operating in Russia need to register with the State Registration Chamber of Commerce and Industry of the Russian Federation. In the case of involvement in the construction market, a licence from the Registration Centre of the Ministry of Construction is required.

## **Establishing an Office**

Foreign firms often conduct marketing activities in Russia through representative offices. Under Russian law, foreign representative offices are not considered to be Russian legal entities; they can conduct marketing activities and sign contracts, but cannot engage in taxable commercial activities.

Representative offices can be in two forms: accredited or non-accredited. Accreditation is the more time-consuming and expensive approach, and it requires the foreign firm to have a Russian government sponsoring organization (usually the Ministry of Foreign Economic Relations or an industry-specific ministry). However, accreditation holds certain advantages in that the accrediting sponsor can issue invitations to foreign personnel

visiting the representative office (which are necessary to obtain Russian business visas) and can assist the office in making business contacts.

Because accreditation involves the submission of various legal and financial documents to the Russian government sponsor, most foreign firms seeking accreditation in Russia retain local legal assistance to handle the application for them.

Both accredited and non-accredited offices must file a registration form with the Russian Tax Inspectorate within one month of establishment of the office.

The office market in St. Petersburg offers good quality renovated space in downtown historic buildings. Larger projects are planned in the next five years, but in the meantime, investor focus is on small- to medium-size developments. Top prices range from US\$600-700 per m<sup>2</sup> per year. Outside the prestigious areas, offices can be rented for US\$450-550 per m<sup>2</sup>. The situation is different in Moscow. It is estimated that only 10 percent of Moscow's 7-8 million m<sup>2</sup> of office space meets Western standards, which is insufficient to meet demand. Although the supply, both of new and renovated space, has been increasing by 50 percent annually, rents are still considerably high. Office leasing rates for high quality office space are \$700-800 per m<sup>2</sup> per year, with service costs varying between US\$50-90 per m<sup>2</sup> per year. To avoid high rents, some companies are choosing to build their own space; construction costs are about US\$2,000 per m<sup>2</sup>.

The leasing of office or warehouse space can be difficult. Clear title is hard to obtain, and most of the property is still state or municipally-owned. Real estate deals in the private sector are frequently subject to fraud. Foreigners need to use a local real estate agent or lawyer when signing a rental contract.

## **Selling Factors and Techniques**

Two related keys to success in supplying the Russian market are focussing on buyers with regular export earnings or good cash flow and not overlooking non-traditional customers.

Foreign suppliers of many types of products, including capital goods and industrial equipment, achieve success by targeting Russian enterprises that export a significant portion of their production

for hard currency or generate good cash flow as a result of domestic sales. A slightly different but equally successful version of this approach is to target regional Russian government authorities located in natural resource-rich areas of the country, as these authorities often receive a share of the export revenues generated by enterprises under their jurisdiction.

## Advertising and Trade Promotion

As the Russian market becomes more competitive and sophisticated, more and more foreign firms are undertaking domestic advertising as an integral component of their marketing strategy.

Advertising through television, radio, print and billboard media has become especially characteristic of the consumer goods and financial services markets. As one would expect, the number of Western as well as Russian advertising agencies active in Russia is growing rapidly.

At present, the legal and regulatory environment for advertising in Russia is not well-developed. Russia's first comprehensive advertising law is now being formulated by the new Russian Parliament's information committee, but relatively little has been publicized about the content of this draft law or the timetable for its completion. In response to several highly-publicized scandals involving Russian investment firms which embezzled money from investors through advertisements promising huge and quick returns, the Russian government signed in 1994 a decree calling for stricter standards of "truth in advertising." However, an assessment of this decree's impact on the local advertising market will be possible only after the publication of implementing regulations.

The recommended marketing techniques are:

- direct contacts with Russian trading firms specializing in building materials and construction equipment;
- exhibiting at national and local levels;
- advertising through the specialized journals; and
- presentations with catalog shows and seminars (availability of technical information in Russian Language is very important).

Both foreign and domestic firms frequently advertise in commercially oriented newspapers and journals in Russia. Trade exhibitions in Russia are a useful mechanism for Canadian suppliers to expand awareness of their product and meet potential buyers and distributors. The Moscow, St. Petersburg and Nizhny Novgorod trade shows and fairs are well established and usually attract large numbers of visitors. However, a direct, aggressive approach and physical presence in the market can be more fruitful than show participation as a market penetration strategy.

## Pricing Products

It is difficult to generalize about the pricing of Canadian goods and services in the Russian market. On the one hand, Russia's per capita income is lower than most Western countries that would argue for pricing imported products toward the low end of the spectrum.

On the other hand, downward pricing may not be appropriate for products that target the fast-growing segment of Russian consumers who, due to their involvement in private business and entrepreneurial activities, possess significant discretionary incomes. In some cases, the relative lack of competition in the Russian market for certain products allows foreign suppliers to introduce new products at higher-end prices. Moreover, Russia's relatively high import tariffs and 23 percent value-added-tax (VAT) put upward pressure on the prices of many imported goods. At any rate, it is worth noting that with almost all prices in Russia now decontrolled and with inflation running at 7-8 percent per month, Russian consumers have grown somewhat accustomed, at least psychologically, to higher prices.

When developing their pricing strategies, Canadian suppliers should also take note of the considerable regional segmentation of the Russian market. While the market for a particular imported product in Moscow or St. Petersburg may be characterized by the availability of several competing import and domestic brands, heavy advertising, good consumer awareness and widespread price competition, the market for the same product in major regional cities such as Yekaterinburg or Novosibirsk may be completely different.

## Selling to the Government

Despite the nearly complete disintegration of the former Soviet Union's centralized trading regime, Russian government organizations (including central, regional and local authorities) are still potential customers for Canadian suppliers in certain instances. Russian government ministries (or ministry-designated trading organizations) often act as purchasing agents for goods and services procured under official tenders financed by international development agencies (e.g., the World Bank, the European Bank for Reconstruction and Development). However, since local governments in general no longer receive substantial subsidies from the federal government, they make purchasing decisions based on local factors and contacts. To take advantage of opportunities at the local and regional level, companies must venture beyond Moscow.

## Protecting Your Intellectual Property

Russia has made progress in establishing the legal basis for protection of intellectual property rights. Laws protecting patents and trademarks in Russia were adopted in late 1992. Russia also subscribes to major international conventions and agreements on intellectual property.

However, Russia's implementation and enforcement of laws protecting intellectual property have not kept pace with legislative developments. Moreover, some lawyers operating in Russia report that adjudication of intellectual property rights disputes in Russian courts is difficult due to the latter's lack of experience with these issues.

## Need for Local Legal Assistance

Russia has yet to develop a codified commercial or tax code. As a result, the great majority of commercial regulations are contained in thousands of individual presidential, governmental and ministerial decrees. Often the relationship between these decrees and existing laws is overlapping, conflicting or unclear.

While one of the key tasks before the recently elected Russian Parliament is to develop a modern, codified body of business law, this will not be accomplished overnight. Therefore, for the

foreseeable future, Canadian firms operating in Russia should use the services of a local lawyer for most legal transactions.

## Regulatory Issues

One of the most pressing issues that defines the business climate in Russia is the lack of legislation in most areas of economic activity. This is due primarily to the fact that there is no political consensus in the State Duma and the Government on how business activities should be regulated, whether private business should be promoted, and the role of foreign investment in Russian society. Not only does this make taxation and business regulation an unpredictable prospect at best, there is no judicial basis for resolution of disputes between individuals or companies.

**Legal Forms of Business Entities:** The legal framework permits the registration of a variety of business entity forms including shareholding companies (both open and closed), limited liability companies, general partnership, and individual entrepreneur. Most business entities in Russia are established as shareholding companies of the open type or general partnerships. An open SHC is established through public offerings and the purchase of shares. In the case of a closed SHC, shares are distributed privately among the founding shareholders.

**Investment Climate:** Russia has made significant steps towards attracting foreign investment. Though the Duma is generally hostile to privatization by foreign companies, it has responded to economic pressure and financial uncertainty. More importantly, some of the larger privatization initiatives through employee buyouts, while impressive on paper, have failed to alter management's old fashioned practices. In addition, they have failed to produce the desired economic results. The new law, while limiting the potential gains of insiders, enhances the rights of local governments. In order to encourage investment and to assist foreign investors, the Russian government has established several sectoral agencies providing information on investment opportunities. Despite these initiatives, the attitude towards foreign involvement has remained ambivalent. There has been a lack of consistent government support, and lack of transparency in dealing with investors. Experts have identified the

following barriers to foreign investment: red tape; lack of consistency in the implementation of a legal framework; excessive bureaucracy; lack of fiscal incentives; political instability; high corporate taxes and employers' contributions; high crime level; and poor telecommunications and technical infrastructure.

**Investment Incentives and Taxation:** Special incentives exist for companies with foreign participation exceeding 30 percent, or investment over US\$10 million. Companies need to be registered and engaged in production activities. Profits are exempt from federal tax for 2 years, the basic tax rate is reduced by 75 percent in the third year and 50 percent in the fourth year.

The taxation of foreign investors in Russia is, in principal, "on equal footing" with local investors. The following tax rates apply: corporate profit tax (38 percent, 13 percent federal tax and 0-25 percent regional), personal income tax (12-30 percent), receivables by non-residents from dividends, interest, royalties (20 percent), social security contributions by employers (39 percent), and value-added tax (20 percent).

#### **Repatriation of Profits and Capital:**

Mechanisms for the conversion and repatriation of domestic currency profits are becoming more widely used and institutionalized. This makes it possible for foreign firms to sell successfully for rubles, without needing to resort to countertrade or barter. The Law on Foreign Investment in the Russian Federation stipulates the full protection of foreign investors. It guarantees that a foreign capital may not be nationalized under any conditions. It also guarantees foreign investors the right to remit, without impediment, their revenues and to receive reimbursement of losses caused by the improper action of state bodies.

**Real Estate:** According to the Land Code, foreigners may own buildings, but are not permitted to own land. Leases grant the tenants "the right to use the land". The standard practice for foreign entities is to buy a one- to three-year lease for residential property, a five-year lease for offices, and a fifty-year lease for office space.

**Exporting:** The significant liberalization of the Russian foreign trade regime since 1992 has been accompanied by the elimination of the government

monopoly over foreign trade and foreign exchange regulations. Foreign companies can import into Russia without first being registered here as a business. If a company chooses to set up a branch or subsidiary or a new company in Russia, it should register with the Moscow Registration Chamber for a business in Moscow, and the regional Registration Chambers for businesses in the regions. There are no quotas on housing-related imports. Imported goods and services must conform to Russian Federation standards. Two major certificates are obligatory for imported goods: a certificate of origin, and a certificate of conformity with safety requirements. All imported goods should be accompanied by the "A" form certificate of origin. Since July 1993, the Russian government enacted a law which requires safety certification for certain products both produced and imported into Russia. Any shipment of such goods must be accompanied by a certificate that confirms their conformity with safety requirements. The law delegates certification authority to the Russian Standards Committee (Gosstandart).

**Customs Duties:** Since April 1, 1993, all goods that enter the customs territory of the Russian Federation are subject to import customs duties. The rates are set by the Russian Federation Law on Import Customs and Tariffs. Import custom duties are paid in rubles or, at the payer's discretion, in hard currency in accordance with the Central Bank exchange rate on the date when the shipper's customs declaration is filed. Import customs duty rates vary by country of origin, with differentiated rates applying to less-developed countries, countries with MFN status, and countries without MFN status. The average rate of duty on housing and building products is between 10-80 percent. Duty is to be paid by all importers within 30 days, and is to be included in the prices of imported goods. Since February 1, 1993, building products imported to Russia are subject to a 20-percent value-added tax (VAT). There is an additional import surcharge.

**Product Certification:** The Russian government has begun enforcing a law requiring certification for products imported into Russia. Any shipment of goods to Russia must be accompanied by documents which prove that the product meets Russian quality, safety, and measurement

standards. Products without this documentation must be certified by the Russian Standards Committee (Gosstandart). The certification of equipment in Russia can take several months, and can be very cumbersome and expensive. Currently, European standards are recognized by Gosstandard, and discussions are underway to establish a recognition of North American and Western European standards.

## EDC Financial Risk Assessment

*The Export Development Corporation (EDC) helps Canadian companies compete in world markets through the provision of financial and risk management services. These include export credit insurance, financing to foreign buyers of Canadian goods and services, and guarantees.*

*The following information was obtained from the EDC Country Risks and Opportunities book (fall, 1996).*

These issues should be taken into consideration when assessing financial risk in Russia.

- In March 1996, Russian authorities implemented a 3-year Extended Fund Facility (EFF) to replace the Stand-by Arrangement. The program makes available SDR6.9 billion (US\$10 billion) in assistance to be disbursed monthly following program reviews, in the same manner as the SBA that it replaces. The disbursement mechanism gives the Fund substantial leverage over the Russian government and—crucially—gives it the means to stop the program if there is evidence of backtracking on reform.
- In August 1996, the International Monetary Fund (IMF) withheld disbursement of the US\$1 billion July loan tranche by reason of insufficient government revenues, which had led to a budget deficit in the first half of 1996 that was two thirds of the planned full-year figure. This drop in government revenues is a result of a propagation of a culture of tax non-payment, which was heightened during the electoral campaign when individuals and companies correctly perceived that the authorities would be unwilling to punish tax dodgers. Following the implementation in August of new measures to improve tax collection, the IMF disbursed both the July and August loan tranches worth about US\$2 billion.
- In September 1996, Russia took a big step toward returning to world capital markets when it announced that a critical mass (US\$20 billion) of its commercial bank creditors had agreed to the rescheduling of its US\$35 billion of London Club debt. The deal is seen as a necessary condition for the launch of Russia's debut Eurobond, which would mark the country's return to world debt markets. It is believed Russia is seeking a rating of between B+ and BB-, which would put the country on par with Brazil and Romania, but would be a sub-investment-grade rating. Russia reached agreement in 1995 with a core group of London Club commercial bank creditors on the basic terms for rescheduling. But since then the banks have been locked in negotiations to get all of Russia's creditor banks to sign-up to the proposal. The US\$20 billion cut-off was seen as the critical level ensuring restructuring would take place.
- In August 1996 new rules were implemented liberalizing foreign investors' access to the government securities market (SKOs). Previously, non-residents wishing to participate in the Russian financial market were required to operate under extremely restricted conditions. But the government securities market will remain risky, and foreign activity is likely to remain limited.

- The Russian economic situation is fragile and could still revert to the chaos that characterized the immediate post-Soviet era. The sum of economic reforms achieved so far are insufficient in themselves to constitute a market-based economy. Rather, they merely constitute the first steps towards a long and difficult reform process which, it is hoped, could ultimately produce a market-based

economy. Whether or not this occurs depends to a large extent on whether Russian authorities stay the course of the difficult reforms undertaken.

The overall collection experience in Russia is poor. Very secure trading terms are the norm. Caution is recommended in regards to credit or financial issues.

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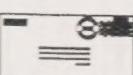
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11 to 20	6.43	12.35	18.08	42.75	38.77	118.75	71.75
21 to 40	6.94	14.90	23.81	58.75	64.65	193.75	103.75
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